§523(a)(6) - Conversion of Collateral - sale out of ordinary course
§727 - False Oath on Schedules Subsequent
Rule 4005, burden - clear convincing
Chalik - Athless, Harvest 7. Civil disclosure

Collier

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE

SOUTHERN DISTRICT OF GEORGIA
Savannah Division

In the matter of: JOHN ALFRED HARMON CHRISTINE MARTIN HARMON (Chapter 7 Case 89-40101) Debtors GREAT SOUTHERN FEDERAL SAVINGS BANK Plaintiff v. JOHN ALFRED HARMON CHRISTINE MARTIN HARMON Defendants	Adversary Proceeding Number 89-4036

FILED
at 10 O'clock & 53 min. A M
Date 11/28/89
MARY C. BECTON, CLERK
United States Bankruptcy Court
Savannah, Georgia

MEMORANDUM AND ORDER

A trial of the above-captioned complaint was conducted on August 18, 1989. After consideration of the evidence and the applicable authorities I make the following Findings of Fact and Conclusions of Law.

FINDINGS OF FACT

1) Debtors, husband and wife, operated a business known as J&C Limited, Inc., d/b/a The Shop for Pappagallo, which had a retail outlet in the Oglethorpe Mall in Savannah, Georgia.

2) Prior to opening the Oglethorpe Mall Pappagallo store in 1983, Mr. Harmon served as president of Morris Levy's in the late 1970's and owned the Harmon Shoe Company from 1980 to 1984, before selling it to an Atlanta businessman. Following 1983, Mr. and Mrs. Harmon also owned and operated another Pappagallo store in Jacksonville, Florida, but due to the inability of Pappagallo to adequately supply it with merchandise and because of other cash flow problems, they ultimately closed that location and moved the inventory to Saint Simons Island, Georgia, where they operated for a few months before closing and transferring the inventory to the Savannah store.

3) The shoes in the Savannah Pappagallo store were financed on an inventory floor plan by United States Shoe Corporation. In 1983, the Harmons began to do business with Great Southern Federal Savings Bank ("Great Southern"), and among the

loans they negotiated was an indebtedness which was secured by a second lien subordinate to that of United States Shoe Corporation on all of the inventory, furniture and fixtures in the Savannah Oglethorpe Mall store.

4) In 1987 the debt to United States Shoe Corporation was fully paid and the lien of Great Southern was elevated to a first lien position.

5) In September of 1988, Debtors, who changed the name of their business to J. Harrington's, approached loan officials at Great Southern seeking additional funds with which to purchase inventory for the following Christmas season. The loan was declined by Great Southern since 1987 had not been a profitable year for the Harmons' business, although 1988 was showing an improvement. At no time did Mr. or Mrs. Harmon inform Great Southern that they intended to close their business or that the failure to advance additional funds would result in such an event.

6) At about the same time, Debtors opened a depository account with First Union National Bank and began depositing the proceeds of all inventory sales made in the ordinary course of business in that account rather than in the account maintained with Great Southern, their main depository account up until that time.

7) Notwithstanding a strong Christmas season in his business, Mr. Harmon concluded, sometime near the end of 1988, that the business was not going to make it and that he would be forced to close and he began to sell off all of his remaining inventory at greatly discounted prices, often as much as 75% off. Ultimately he also sold all of the furniture, fixtures and equipment that were located in the store and closed the business near the last day of the year 1988. Debtors conducted a sale of their merchandise at increasing discounts as time went on during the entire month of December. It was not initially advertised as a liquidation sale. However, they were not ordering or receiving any additional goods during that time.

8) None of the proceeds of the final liquidation were paid over to Great Southern to liquidate any of the outstanding balance on the inventory loan.

9) As of August 17, 1989, Mr. and Mrs. Harmon were indebted to Great Southern either directly or by way of guarantees in an amount exceeding $250,000.00. Of that amount, the balance on the loan secured by the inventory in the Pappagallo store was $51,091.15.

10) The first lien held by United States Shoe Corporation on the store's inventory secured a 1983 loan made by United States Shoe which would be amortized over a period of four years and thus if paid in the ordinary course of events would have been paid off in 1987. Indeed the Debtors revealed on a June, 1987, financial statement that there was no further debt outstanding to United States Shoe. However, United States Shoe did not cancel the UCC-1 financing statement which it had recorded and in January of 1988, United States Shoe renewed its UCC to extend its validity. Great Southern was not aware of the renewal of the UCC-1 by United States Shoe. The balance owed to United States Shoe as of the date of filing was approximately $87,000.00, evidently for debts incurred after 1987.

11) The Debtor maintained no records of who purchased the inventory, furniture, fixtures and equipment. Mr. Harmon states that his decision to close was made during the last few days of December when he was confronted by a State sales tax lien on his checking account. This prevented him from keeping his rent to Oglethorpe Mall current and paying other operating expenses. He states that all proceeds of the sale were deposited into the First Union account and were used to purchase new merchandise and to pay some of his tax obligations and rent but that neither he nor his

wife took any salary out of the business during the final liquidation sale.

12) Great Southern brings this action under 11 U.S.C. Section 523(a)(6), arguing that the sale of merchandise under conditions which it alleges to be out of the ordinary course of business constitutes a conversion, and therefore results in a non-dischargeable debt obligation. There is no contention that any loan document executed by Mr. or Mrs. Harmon obligated them to pay over the proceeds of their on-going inventory sales to Great Southern. That is, there is no violation of a fiduciary or trust obligation to account for proceeds as there is in businesses selling expensive large ticket consumer goods. Rather, the contention is that at whatever point the decision was made that the business would be closed, all subsequent sales of pledged property without an accounting to the creditor constitutes a willful and malicious injury.

13) Great Southern alternatively brings this action under 11 U.S.C. Section 727(a)(4), alleging that Debtors should be denied a discharge as to any Great Southern debts because the Debtors have made false oaths and have failed to fully disclose the nature and extent of their assets and liabilities in their schedules.

14) For example, the Debtors acknowledged that they owned stock in John Mar Shoes, d/b/a Hushpuppy Corporation, and owned such interest at the time their case was filed. Despite this admission, schedules filed in conjunction with their case state that this interest was sold in July, 1988.

15) Debtors owned a 50% interest in a business known as Cinnamon Jacks as of the date of filing and still own such interest but this interest was also not properly revealed in their schedules.

16) Debtors also owned a 1984 Honda automobile which was not properly listed in their schedules but they did offer to surrender said vehicle to Great Southern, which holds a security interest in it. Debtors failed to reveal in question "12" of their Statement of Affairs a transfer of certain real property within one year of filing their case. However, the fact that such a transfer occurred was revealed in their Schedule B-4.

17) The Debtors further failed to list the First Union Bank account which they opened during 1988 and which was their primary business account as of the date their business was closed.

CONCLUSIONS OF LAW

The issue squarely presented is whether the sale of assets by a business debtor which has no obligation to tender any specific sum of money to a secured creditor on a transaction by transaction basis rises to the level of a willful and malicious injury when the debtor switches from an ongoing business mode to a liquidation mode.

Plaintiff seeks to have the debt owing to it excepted from discharge pursuant to Section 523(a)(6), which provides in relevant part that:

> (a) A discharge . . . does not discharge an individual debtor from any debt--
>
> (6) for willful and malicious injury by the debtor to another entity or to the property of another entity.

The dominant purpose of the bankruptcy laws is to provide the debtor with comprehensive, needed relief from his financial burden by releasing him from virtually all of his debts. To accomplish this goal, the courts have narrowly construed exceptions to discharge against the creditor and in favor of the

bankrupt. Thus, the burden of proof lies with the creditor to show that the particular debt falls within one of the statutory exceptions. The exceptions to discharge were not intended and must not be allowed to override the general rule favoring discharge. Murphy & Robinson Investment Co., v. Cross (Matter of Cross), 666 F.2d 873, 879-80 (5th Cir. 1982) (footnotes and citations omitted). When a creditor seeks to have a debt determined to be non-dischargeable, the creditor bears the burden of proving each element of the applicable code section by clear and convincing evidence. Schweig v. Hunter (In re Hunter), 780 F.2d 1577, 1579 (11th Cir. 1986); Matter of Brinsfield, 78 B.R. 364, 368 (Bankr. M.D.Ga. 1987).

Thus, in order to except a debt from discharge under Section 523(a)(6), the creditor must prove three elements by clear and convincing evidence:

1) That the debtor injured another entity or the property of another entity;

2) That the debtor's actions were deliberate and intentional; and

3) That the debtor's actions were malicious.

The Eleventh Circuit in Chrysler Credit Corp., v. Rebhan, 842 F.2d 1257 (11th Cir. 1988), approved and adopted the

approach set forth in United Bank of Southgate v. Nelson, 35 B.R. 766 (N.D. Ill. 1983), in construing the "willful and malicious" elements of 11 U.S.C. Section 523(a)(6). Under Southgate, "willful means deliberate or intentional" and "malice for purposes of section 523(a)(6) can be established by a finding of implied or constructive malice". Rebhan, 842 F.2d at 1263. "No showing of personal hatred, spite or ill-will is required to prove an injury malicious; it is enough that it was 'wrongful and without just cause or excuse'." In re Lindberg, 49 B.R. 228, 230 (Bankr. D.Mass. 1985) (quoting In re Askew, 22 B.R. 641, 643 (Bankr. M.D.Ga. 1982), aff'd, 705 F.2d 469 (11th Cir. 1983). Hence, an injury is considered "willful" if it is intentional and "malicious" if it results from an intentional or conscious disregard of one's duties. Id.

The conversion of another's property without his knowledge or consent, done intentionally and without justification and excuse, to the other's injury, is a willful and malicious injury within the meaning of the Section 523(a)(6) exception. Matter of McLaughlin, 14 B.R. 773, 775 (Bankr. N.D.Ga. 1981); 3 Collier §523.16 at p.523-116 (15th Ed. 1989).[1]

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[1] Although §523(a)(6) does not expressly so provide, "willful and malicious injury" can include a willful and malicious conversion of security. S. REP. NO. 989, 95th Cong., 2d Sess. 79, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787; In re Pommerer, 10 B.R. 935, 940 (Bankr. D.Minn. 1981). "In proceedings involving alleged conversion of secured collateral, 'malice' is shown by proof that a debtor disposed of security with the specific knowledge that the

"[A] willful and malicious injury does not follow as of course from every act of conversion, without reference to the circumstances. There may be an injury which is innocent or technical, an unauthorized assumption of dominion without willfulness or malice. There may be an honest but mistaken belief, engendered by a course of dealing, that powers have been enlarged or incapacities removed. In these and like cases, what is done is a tort, but not a willful and malicious one." Davis v. Aetna Acceptance Co., 293 U.S. 328, 331, 55 S.Ct. 151, 153 (1934) (citations omitted).

To meet the willful and malicious standard of Section 523(a)(6) the debtor must be aware that the act violates the property rights of another. Brinsfield, 78 B.R. at 370. In assessing the intent of the debtor, a businessperson will be held to a higher standard than an ordinary individual where it is clear

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disposition would invariably and indubitably cause harm to the secured creditor or by proof that the debtor had the specific intention of causing harm to the secured creditor by the disposition. A debtor's sale or other disposition of secured property is not an act which invariably implies malice toward the secured party." In re Eberle, 61 B.R. 638, 648 (Bankr. D.Minn. 1985) (emphasis original) (citing Davis v. Allen Acceptance Corp., 293 U.S. 328, 332, 55 S.Ct. 151, 153, 79 L.Ed. 393 (1934). Rather, this factual determination may be made only on a case by case basis. Id. A showing that the debtor was aware of the secured creditor's specific rights to the security and the proceeds thereof yet deliberately disregarded those rights is sufficient. Id.

that that businessperson would be more knowledgeable of the natural consequences of his acts. Matter of Ricketts, 16 B.R. 833, 834-35 (Bankr. N.D.Ga. 1982).

The debtors in the present case were no novices to the business world. To the contrary, they were quite experienced in the retail business and in inventory financing. Mr. Harmon was affiliated with Morris Levy's from 1973-1979 and held the position of president of that firm for at least two years. In addition, the debtors owned or operated Harmon Shoes, d/b/a/ Connie's Shoes from 1980 to 1984; Hunter Cosmetics from November, 1986 to September, 1987; J & C Harmon Enterprises, Inc., d/b/a Shop of Pappagallo in Jacksonville, Florida, from September, 1985 to May, 1988; J.H. Clothiers, Inc., d/b/a Harrington's on St. Simons Island from June, 1988 to September, 1988; Jon Mar Shoes, d/b/a Hushpuppy Shoes, from August, 1985 to the present; J & C Limited, Inc., d/b/a Shop of Pappagallo from 1983 to January, 1988; and Cinnamon Jacks, Inc., d/b/a Cinnamon Jacks from November, 1987, to the present.

In the same light, the debtors were not novices at closing businesses. The Debtors' shoe business was sold in 1984, Hunter Cosmetics went out of business in 1987, the Jacksonville operation went out of business in May, 1988, and the St. Simons operation closed in September, 1988. This all preceded the closing

of the Oglethorpe Mall business on January 2, 1989. The latter is the basis for the Section 523 dischargeability action brought in this case.

This case arises out of a calculated "out of the ordinary course of business" liquidation sale of everything in the store--furniture, furnishings, equipment, as well as inventory. This liquidation was made with full knowledge by established business people, experienced with retail inventory financing arrangements, that this property was held as collateral by the bank on a loan.

The debtors knew as early as September, 1988, that the bank was not in a position to extend them an additional loan until profits were improved somewhat. Once this was known, instead of closing the business and turning the merchandise and equipment over to the bank, the debtors elected to drain the business dry until disposing of everything at a "sell all" sale on January 2, 1989.

An exercise of dominion or control over secured property in a manner which is inconsistent with the rights of the secured party constitutes, as to him, a conversion of that property. Trust Company of Columbus v. Associated Grocers Co-op, Inc., et.al., 152 Ga. App. 701, 263 S.E. 2d 676 (Ga. App. 1979). The evidence shows

that Great Southern held a valid perfected security interest in all of the inventory, furniture and fixtures in the Savannah Oglethorpe Mall Pappagallo store. The evidence further shows that the debtors were experienced retailers who were aware or should have been aware of the rights of their secured financiers. Yet, contrary to the rights of Great Southern, debtors sold all of the furniture, inventory and equipment without notifying Great Southern or remitting the proceeds to it.

It is difficult to prove that one holds a purposeful intent to harm another. However, when one acts with the knowledge that his act of conversion is in contravention of the rights of a secured creditor yet proceeds deliberately and intentionally in the face of that knowledge, without justification or excuse, this Court will infer malice and render such debt non-dischargeable under Section 523(a)(6). Inasmuch as I find that the debtors herein willfully and maliciously converted property of Great Southern to its injury, I find that Section 523(a)(6) renders such debt non-dischargeable.

Great Southern has argued in the alternative that the Debtor should be denied a discharge altogether pursuant to Sections 727(a)(4)(A), 727(a)(2) and 727(a)(3). Under Bankruptcy Rule 4005, the burden of proof falls upon the creditor objecting to the Chapter

7 debtor's discharge under 11 U.S.C. Section 727, and that burden must be met with clear and convincing evidence. In re Mart, 87 B.R. 206 (Bankr. S.D. Fla. 1988); In re Cohen, 47 B.R. 871 (Bankr. S.D. Fla. 1985).

Debtors contend that it somehow does not matter that their ownership interests in two corporations were omitted from Schedule B-2(t) since the interests presently have no value to the estate. This argument cannot be countenanced as it entirely ignores binding precedent in this circuit. The Eleventh Circuit adopted the clear rule that a debtor may not escape the Section 727 denial of discharge for making a false oath by merely stating that the omitted or falsely stated information concerned a worthless business relationship or holding. In re Chalik, 748 F.2d 616, 618 (11th Cir. 1984). The Chalik Court deemed the subject matter of a false oath "material" and thus sufficient to bar discharge if it "bears a relationship to the bankrupt's business transactions or estate, or concerns the discovery of assets, business dealings, or the existence and disposition of his property". Id.

In Chalik, the debtor omitted from his schedules twelve corporations in which he held substantial interests. Debtor subsequently revealed the interests at a Rule 205 examination. The debtor maintained that the omission was immaterial because the

corporations were worthless but the Eleventh Circuit affirmed denial of discharge, finding that the omission interfered with the investigation of the debtor's financial condition, prior dealings, and the disposition of his property.

Similarly, the Debtors herein failed to disclose corporate and other assets which may have aided in the investigation of the Debtors' financial condition, prior dealings, and the disposition of their property. However, I find that the Debtors' omissions may not support the denial of a discharge under Chalik.

Although it is true that the Debtors made errors on their Bankruptcy Schedules and Statements, I will reserve ruling on Great Southern's Section 727 objections for further evidentiary hearings. The purpose of the provision denying a discharge if an oath is knowingly and fraudulently made is to insure that a debtor supplies accurate, complete and dependable information that can be relied upon by anyone with reason to inquire into the statement or schedules. In re Seablom, 45 B.R. 445 (Bankr. N.D. 1984). A discharge will not be denied where an honest mistake has been made in the debtor's schedules or statement of financial affairs. In re Cycle Accounting Services, 43 B.R. 264 (Bankr. Texas 1984). "If the items were omitted by mistake or upon honest advice of counsel, to whom the debtor had disclosed all the facts relative to such items,

that declaration will not be deemed willfully false, and discharge should not be denied because of it." 4 Collier §727.04 at 727-61 (15th Ed. 1989).

Debtors' schedules do not facially show the requisite wrongful intent to justify a denial of discharge pursuant to 11 U.S.C. Section 727. "The provisions denying a discharge to debtor are generally construed liberally in favor of the debtor and strictly against the creditor." 4 Collier §727.01A at 727-9 (15th Ed. 1989). Debtors initially failed to disclose the conveyance of Mrs. Harmon's 1/9th undivided interest in real property on Schedule B-1. However, that interest was disclosed on Schedule B-4 as "real property transferred to father 9/88". I find that the subsequent reference cures the omission from Schedule B-1. Secondly, the Debtors failed to disclose their ownership of a 1984 Honda automobile in Schedule B-2 "Personal Property". However, this asset was disclosed elsewhere, in Schedule A-2 "Creditors Holding Security", as having a market value of $2,500.00 and a claim amount of $860.00. In addition, the Debtors listed the auto in Form 8A "Statement of Intention Re: Secured Consumer Debts" and stated their intention to surrender the auto. Again, I find that the subsequent references cure the omission from Schedule B-2. Regarding the omission of tax liabilities, I accept the explanation that the Debtors failed to list their tax liabilities because they

were unsure of the extent of such liability, particularly that with the State of Florida. If a debtor is uncertain as to the need to include certain assets or liabilities in its bankruptcy schedules, it should disclose such transactions fully for such legal interpretations as may be warranted. In re Chambers, 36 B.R. 791 (Bankr. Ky. 1984). Nonetheless, I find that the failure to list the tax liabilities does not warrant denial of discharge.

I am, however, disturbed by the Debtors' failure to list their interests in two corporations in Schedule B-2(t) of their petition. It is true that the Debtors did list an ownership interest in both corporations in item 2(c) of Form 7, but both listings were quite misleading. First, as to the Jon Mar Shoes, Inc., d/b/a Hushpuppy Shoes interest, the Debtors stated that they had sold this interest to Martin Brody in July, 1988. Debtors subsequently admitted at the Section 341 Meeting that Mr. Harmon still retains an interest in that corporation. Secondly, the Debtors' interest in Cinnamon Jacks, Inc., d/b/a Cinnamon Jacks, was listed in the past tense, as though it had also been sold. Again, this was corrected at the Section 341 Meeting. The subsequent disclosure of material assets which were omitted from the Debtors' schedules will not cure nondischargeability for the making of a false oath under Section 727. Chalik, 748 F.2d 616. However, in this case we are not faced with a complete omission of these

interests from the schedules. Unlike the debtor in Chalik, the Harmons did disclose at least a past ownership in both corporations. As I interpret Chalik a false oath must be "materially" false in order to deny a debtor's discharge.

A debtor's statement under oath is materially false under that decision if it fails to disclose even a worthless asset if the failure to disclose that asset interferes in some way with creditors' ability to investigate the debtor's financial dealings. Although I will not excuse misleading statements in petitions before this Court, I do find that a creditor who wished to inquire into the conduct of Debtors' business affairs had sufficient information as to the identity of Debtors' business interests to make further inquiry from Debtors' disclosure of their "prior" ownership of Jon Mar Shoes and Cinnamon Jacks.

A debtor's statement under oath is, alternatively, materially false if it fails to disclose ownership of a valuable asset. In this case Debtors' schedules initially represented that as of the date of filing they owned no present interest in either corporation. Both corporations are open, apparently viable, and doing business in Oglethorpe Mall in Savannah. One would presume that as going concerns they have some intrinsic value. Accordingly, the failure to disclose the existence of a present ownership

interest might well lead to denial of discharge. However, for reasons unclear in the record the Chapter 7 Trustee on April 5, 1989, abandoned any interest in these corporations after Debtors corrected their schedules and revealed the husband's interest in them. Debtors' "Amendment to Petition" filed on March 27, 1989, scheduled the value of both interests as "unknown". Debtors claimed no interest in the corporations as exempt property in their Schedule B-4.

It is axiomatic that a trustee may abandon only property that is "burdensome" or of "inconsequential value" to the estate. Therefore, the fact that the Trustee has abandoned its interest in both corporations raises an inference that any ownership interest the Debtors may have in Cinnamon Jacks, Inc., or Jon Mar Shoes, Inc., is of inconsequential value. However, I will leave the record open for the Debtors, creditors and Trustee to submit evidence regarding the value of these enterprises in order that I may make an independent determination of whether the interest in these corporations was of sufficient value that its non-disclosure as a present ownership interest in the original schedules can be found to be materially false.

A continued trial for that purpose will be held

on Wednesday, December 20, 1989
at 10:00 o'clock a. m.
Bankruptcy Courtroom 228
United States Courthouse
Savannah, Georgia

Notice of this trial assignment shall be served on the parties to this action, the Chapter 7 Trustee, and the United States Trustee.

However, as to the Section 523(a)(6) count, Plaintiff is entitled to judgment in the amount of $51,091.15, plus interest after August 18, 1989, at the contract rate, for the reasons stated herein.

Lamar W. Davis, Jr.
United States Bankruptcy Judge

Dated at Savannah, Georgia
This 22nd day of November, 1989.